

Did NAFTA Cause a “Giant Sucking Sound”?

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The North American Free Trade Agreement (NAFTA) passed Congress amidst contentious debate in 1993. Detractors argued that it would produce an exodus of jobs while proponents argued that it would create jobs. We examine the economic effects of NAFTA. The evidence indicates that while the employment effects have been small, NAFTA has caused an explosion of trade. This increase in exports and imports has multiplied gains from trade. In addition NAFTA helped Mexico recover quickly from the 1994–1995 peso crisis and provided a political anchor for Mexico's attempts to privatize, deregulate, and liberalize. The resulting growth and stability in Mexico have benefitted the U.S., which shares a 2,000 mile border with Mexico.

I. Introduction

The North American Free Trade Agreement (NAFTA) sparked virulent debate before Congress ratified it in 1993. Labor unions and populist politicians claimed that NAFTA would cost millions of American jobs. Business leaders and others countered that NAFTA would produce millions of American jobs. The original debate generated intense heat; we seek to shed light on how NAFTA has affected the economy over the last eight years.

While the evidence indicates that NAFTA has had little effect on U.S. employment, it also shows that NAFTA has produced several benefits. The agreement contributed to an explosion of exports and imports between the U.S. and Mexico, producing gains from trade as specified by the theory of comparative advantage. It also helped Mexico weather the peso crisis of 1994–1995. During the 1981–1982 crisis, Mexico raised tariffs on U.S. goods to 100 percent and imposed non-tariff barriers. During the 1994–1995 crisis, in contrast, Mexico continued to lower tariffs with the U.S. according to NAFTA stipulations. The resulting open borders with the U.S. contributed to Mexico's rapid recovery. In addition NAFTA served as the political anchor behind recent attempts to privatize, deregulate, and liberalize the Mexican economy. The economic freedom and openness that has emerged has made Mexico's economy one of the strongest in Latin America. The stability and prosperity in Mexico in turn benefit the U.S. since the two countries share a 2,000 mile border.

Section II outlines the legal changes mandated by NAFTA. Section III reviews the predictions that Ross Perot, mainstream economists, and others made concerning NAFTA. Section IV considers the effects of NAFTA on U.S. employment. Section V considers other effects of NAFTA. Section VI concludes.

II. *The NAFTA Agreement*¹

Before NAFTA was implemented, the trade-weighted average tariff and tariff equivalent of quotas was 4 percent for the U.S. and 10 percent for Mexico (Burfisher et al., 2001). U.S. tariff rates, which exceeded 30 percent in the early 1930s, had fallen steadily since then. Mexican tariff rates, which equaled 24 percent in the early 1980s, began falling after Mexico joined the GATT in 1986.

While average tariff rates were low, certain sectors faced high tariffs and non-tariff barriers. Agricultural imports into Mexico were subject to import licences. Automobile imports into Mexico faced high hurdles and textile imports into Mexico were limited by quotas. U.S. financial firms were prevented from owning Mexican firms outright. The U.S. in turn had major restrictions on imports of steel, agriculture, and textiles. As Lustig (2001) notes, many Mexican products faced U.S. tariff rates exceeding 20 percent.

Under NAFTA, tariffs on half of the import categories were eliminated immediately, and other tariffs and non-tariff barriers were to be phased out. Most tariffs were eliminated over five years, while some would remain in effect for 10 or 15 years. In agriculture, for instance, Mexico replaced import licenses by tariffs, and agreed to phase out these tariffs within 15 years. In automobiles, Mexico eliminated tariffs on pickup trucks, reduced tariffs on cars by 50 percent immediately, and agreed to phase out the remaining tariffs on cars over 10 years. In textiles, Mexico agreed to remove quotas over 10 years. In the financial sector, it phased out limits on U.S. ownership of Mexican firms over 7 years. As Lustig (2001) observes, the phase-out period was designed to soften the impact of liberalization on sensitive sectors in Mexico.

NAFTA also promoted free trade in other ways. NAFTA guaranteed national treatment to service providers from other NAFTA countries: Under the national-treatment obligation, a government is prohibited from applying tougher standards to imported products than domestic products. NAFTA guaranteed that investors would be able to freely convert local currency into foreign currency at the prevailing exchange rate. It also excluded firms in partner nations from tariffs arising from safeguard actions unless that nation was a major exporter. It provided for judicial review by binational panels in the case of antidumping rulings. Finally, it strengthened intellectual property rights.

III. *Predicted Effects of NAFTA*

NAFTA's chief detractor was Ross Perot. In a book with Pat Choate (Perot and Choate, 1993) he predicted that NAFTA would do massive damage to the U.S. economy and U.S. workers. He argued that the agreement would cause an exodus of U.S. factories to Mexico to take advantage of low-wage Mexican labor. This, he claimed, would unleash a flood of cheap exports from Mexico into the U.S. Perot initially argued that the resulting surge of imports would cost 3 million U.S. jobs, but in his book with Choate he raised the ante, arguing that 6 million jobs were at risk. In a memorable quote, he said there would be a "giant sucking sound" of jobs moving south to Mexico.

Labor unions and other opponents of NAFTA made similar arguments. Patrick Buchanan, one-time presidential candidate, for instance, also argued that lower wages in Mexico inevitably would result in losses of American jobs and investment.

Perot argued that since Mexico had lower wage rates than the U.S., a social tariff was necessary to equalize competition between the two countries. Perot wanted the tariff to raise the prices of Mexican goods to equal the prices of U.S. goods. The tariff would then be lowered as Mexican wages began catching up with U.S. wages.

Economists had trouble taking these anti-NAFTA arguments seriously. Most mainstream forecasts indicated that NAFTA would have a small, but positive, effect on the U.S. economy. The effect was expected to be small because U.S. output far exceeded Mexican output; Mexican exports into the U.S. were minuscule; and U.S. tariffs on Mexican products were already small. U.S. output in 1993 was 20 times larger than Mexican output. Mexican exports into the U.S. amounted to only 0.5 percent of U.S. gross domestic product. Average U.S. tariff rates and tariff equivalent of quotas equaled 4 percent. Even if cutting these tariff rates to 0 percent caused Mexican exports to double, this would only equal 1 percent of U.S. output. It was hard to believe that such a change would devastate the U.S. economy, as Perot argued.

Furthermore, Perot's claim that lower wages in Mexico would cause a mass exodus of factories from the U.S. was suspect. Firms are concerned with wages relative to productivity, or unit labor costs. The OECD (1999) reports that unit labor costs in Mexico in 1993 were almost 50 percent higher than unit labor costs in the U.S. When one considers that Mexico's transportation and communication systems are less efficient, Mexican crime rates are higher, and Mexico is farther from U.S. customers, the disincentive for U.S. firms to move to Mexico increases (Samuelson, 1993).

While the economic rationale for job migration to Mexico was not strong, economists did anticipate efficiency gains (i.e., gains from trade). Hufbauer and Schott (1992) stated that the efficiency benefits and growth stimulus could exceed \$15 billion annually. They argued that this figure, rather than jobs gained or lost, was the true measure of the economic gain from NAFTA.

The potential for gains from trade, as spelled out by the theory of comparative advantage, is compelling in the case of trade between the U.S. and Mexico. The theory indicates that when two countries differ, each can benefit by producing what it makes relatively more efficiently and trading for what it makes relatively less efficiently. In the case of the U.S. and Mexico, the U.S. contains more higher skilled, higher productivity workers, and Mexico contains more lower skilled, lower productivity workers. Both countries would gain in aggregate if the U.S. specializes in producing goods requiring higher skilled labor and Mexico specializes in producing goods requiring lower skilled labor. The fact that the two countries are contiguous also implies that transportation costs will be low.

However, while free trade will benefit both countries overall, there are losers from expanding trade. Thorbecke (1997) presented evidence from lobbying patterns on

NAFTA indicating that the Heckscher-Ohlin model provides a good framework for analyzing the distributional effects of NAFTA. In the Heckscher-Ohlin model with two factors and complete factor mobility, the Stolper-Samuelson (S-S) theorem indicates that trade liberalization benefits the abundant factor and harms the scarce factor. Since the U.S. is a capital abundant country, the Stolper-Samuelson theorem implies that capital will gain from NAFTA while labor will lose. Leamer argued that to analyze the distributional effects of NAFTA it is necessary to include three factors: capital, high-skilled labor, and low-skilled labor. He argued that capital and high-skilled labor in the U.S. were likely to gain and that low-skilled labor in the U.S. was likely to lose.

Many studies sought to predict the effects on low-skilled labor. As Burfisher et al. (2001) discuss, the consensus of these studies was that the negative effects on low-skilled workers would be negligible.

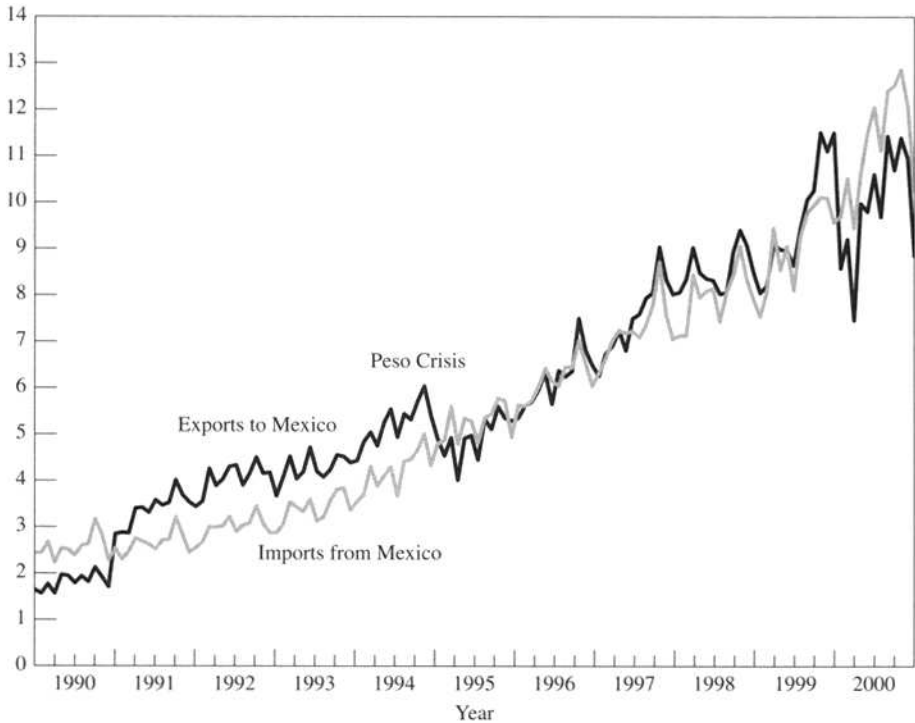
IV. The Actual Effects of NAFTA on Employment

Opponents of NAFTA claim that NAFTA did lead to large job losses. The AFL-CIO commends the Economic Policy Institute study entitled (EPI, 2001) "NAFTA at Seven" which discusses how U.S. net exports with Mexico and Canada changed from a \$16.6 billion deficit in 1993 to a \$62.8 billion deficit in 2000. The study (p. 3) then states, "As a result, NAFTA has led to job losses in all 50 states and the District of Columbia." The paper quantifies the job losses that NAFTA caused by producing a trade surplus in Mexico at 367,000. Patrick Buchanan similarly attributes Mexico's trade surplus to NAFTA.

The argument that NAFTA cost 367,000 jobs, while only 6 percent of the number of jobs claimed to be at risk by Perot and Choate (1993), is based on faulty analysis. It assumes first that NAFTA led to Mexico's trade surplus and second that the trade surplus led to American job losses. Both of these inferences are incorrect.

Figure 1 sheds light on the factors leading to Mexico's trade surplus by showing that the shortfall of U.S. exports to Mexico relative to imports emerged at the beginning of 1995, immediately following the peso crisis of December 1994. A large body of theoretical and empirical evidence indicates that exports are positively related to foreign income and the real exchange rate and that imports depend positively on domestic income and negatively on the real exchange rate (Dornbusch et al., 1998). Net exports (equal to exports minus imports) are thus positively related to foreign income and the real exchange rate and negatively related to domestic income. The Mexican Central Bank reports that the real exchange rate depreciated 30 percent between December 1994 and January 1995 and that output (measured by industrial production) fell 12 percent between December 1994 and April 1995. Figure 1 shows that Mexico's trade surplus in January 1995 was due to a fall in U.S. exports to Mexico, not to an increase in imports from Mexico that NAFTA's detractors warned about. Thus the trade surplus was due to a fall in exports caused by the collapse in the peso's value and in Mexican income during the peso crisis, not from NAFTA.

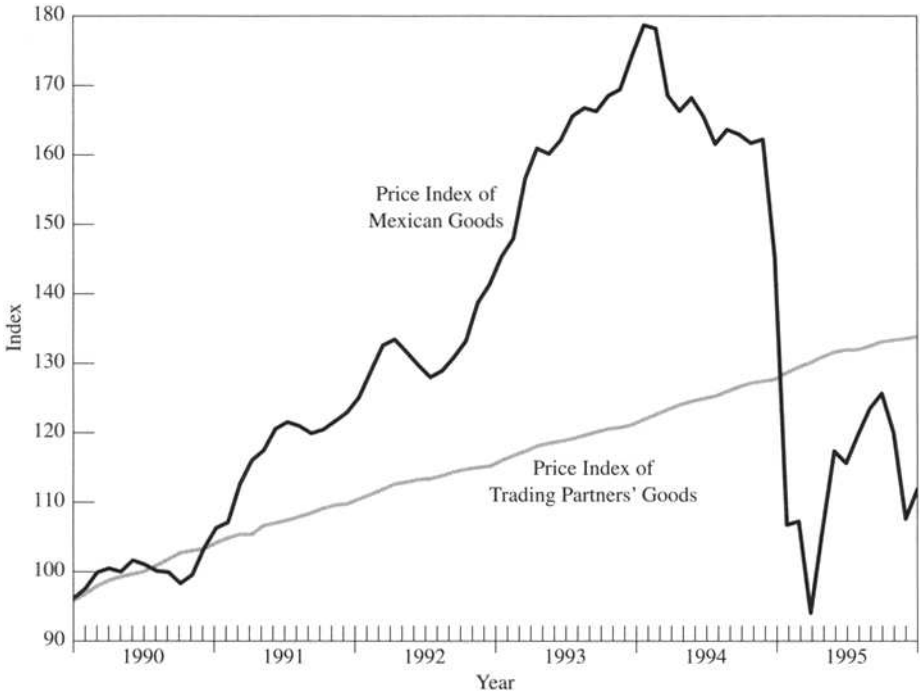
Figure 1
U.S. Exports to and Imports from Mexico, 1990–2000
 (Billions of Dollars)



Someone could object that the peso crisis was due to NAFTA, but this was not the case. Figure 2 shows the price of Mexican products measured in the currencies of its trading partners versus the price level of its trading partners (a similar Figure over a different sample period appears in Dornbusch et al., 1998). Figure 2 indicates that the peso was overvalued by 40 percent before the crisis. Furthermore, this overvaluation was not market-determined but the result of a pegged exchange rate by the Mexican authorities. When the Federal Reserve began raising interest rates in 1994, capital flows into Mexico slowed. As Hakim (1995) discusses, the overvalued peso, combined with the outflow of short-term capital to the U.S. following the interest rate hikes created a snowball process leading to the devaluation.

Even if NAFTA had caused the trade surplus in Mexico, however, this would not have led to a net loss of jobs in the U.S. A decline in U.S. net exports, like a decline in consumption or investment spending, represents a decrease in aggregate demand. To know whether this will lead to a loss of jobs it is necessary to know the level of

Figure 2
*Price Index of Mexican Goods, Measured in
Terms of Trading Partners' Currencies and Price Index of
Trading Partners' Goods, 1990–1995*



aggregate demand relative to potential aggregate supply. As Federal Reserve Chairman Alan Greenspan (2000) stated in 2000, when the EPI paper was written, aggregate demand exceeded potential aggregate supply. Greenspan discusses how an increase in demand when output exceeds potential can cause wages to increase faster than productivity growth and cause inflation. The decline in U.S. net exports, according to Greenspan, acted as a safety valve protecting the economy from overheating. Thus, Mexico's trade surplus was not costing jobs but rather keeping the U.S. economy in balance and forestalling interest rate increases by the Federal Reserve.

An approach that does shed light on the employment effect of NAFTA is to consider what happened to foreign direct investment (FDI). If U.S. firms were moving jobs to Mexico, they would have to build factories in Mexico which would increase FDI. According to the OECD, the ratio of FDI into the U.S. to FDI into Mexico in the first year of NAFTA (1994) was 4.5 (OECD, 1999). In 1999, the last year for which data are available, this ratio equaled 23.4. Thus FDI into the U.S. has increased far more

rapidly than FDI into Mexico, implying that the jobs created by investment flows into the U.S. far exceed the jobs lost due to capital flows into Mexico. In addition, FDI into Mexico in 1999 was less than 1 percent of domestic capital formation in the U.S. Thus any employment losses from FDI entering Mexico would be swamped by the employment gains arising from U.S. capital formation.

Another approach that sheds light on the employment effect of NAFTA is to look at the NAFTA Trade Adjustment Assistance (NAFTA-TAA) program. NAFTA-TAA provides training and extended unemployment benefits to workers losing jobs due to trade with Canada or Mexico. The benefits are provided under the condition that the eligible workers obtain training. The program provides benefits to dislocated workers when either increased imports from NAFTA countries were an important cause of the job loss or when movement of the plant to a NAFTA country led to the separation.

For the first 65 months, the number of workers certified as being dislocated by trade with Mexico averaged less than 3,000 per month.² This number might understate the total number of displacements due to trade with Mexico if some workers were unaware of the program or chose not to participate in it.

While the NAFTA-TAA data might understate the losses, Hinojosa et al. (2000) perform a sector-by-sector analysis of the impact of Mexican imports on U.S. employment that overstates the employment effects. As Hinojosa et al. discuss, the sectoral estimates overstate the employment losses because they assume that productivity remains fixed as trade increases. Over a seven-year period, they find that increased imports from Mexico resulted in job losses averaging 3,200 workers per month.

Whether one uses the NAFTA-TAA data or the Hinojosa et al. approach, it is clear for a couple of reasons that the net job losses from NAFTA are minuscule. First, these numbers do not include the job gains due to U.S. exports to Mexico. As Figure 1 shows, exports to Mexico have increased rapidly over the last seven years. Second, even ignoring the job gains from exports, 3,200 job losses per month is dwarfed by the 200,000 jobs per month created on average since 1993 (Hinojosa et al., 2000). There has thus been no giant sucking sound of jobs moving south; there has, if anything, been a faint trickling noise.

V. Other Effects of NAFTA

While there has been little net employment loss in the U.S. due to NAFTA, there have been other noteworthy effects. One effect has been to hold down inflation in the U.S. Competition from producers in Mexico and other countries has limited the ability of firms to raise prices. General Electric chairman John F. Welch, speaking of this phenomenon, said "There is no inflation. . . . There is no pricing power at all" (Stevenson, 1996, p. 15). David Wyss, chief economist at Standard & Poors' Corporation, finds that NAFTA has reduced the annual inflation rate in the U.S. by 0.1 percentage point (Whalen et al., 2001). The effect is small because, as discussed above, imports from Mexico are small relative to U.S. output.

NAFTA has also probably reduced the natural rate of unemployment in the U.S. As Zoellick (2001) argued, by exposing U.S. firms to the discipline of competition, NAFTA has increased productivity. Blanchard and Katz (1997) discussed how increased productivity can lower the natural rate of unemployment. Moreover, the ability to relocate in Mexico has probably weakened the power of labor unions. Gordon (1997) discusses how the natural rate of unemployment tends to fall as unions become weaker. While the drop in the natural rate due to NAFTA has not been measured quantitatively, the fact that the Mexican economy is small relative to the U.S. economy implies that the effect will be small.

Where NAFTA has had a larger effect is in contributing to the explosion of trade between the U.S. and Mexico. Figures 3 and 4 show the growth of U.S. exports to and imports from Mexico compared with U.S. exports to and imports from the world over the last decade (similar Figures appear in Burfisher et al., 2001). Clearly U.S. trade with Mexico has soared, both absolutely and relative to the rest of the world.

This explosion of exports and imports between the U.S. and Mexico has led to gains from trade as described by the theory of comparative advantage. Whalen et al.

Figure 3
*Growth of U.S. Exports to Mexico and
to the Rest of the World, 1990–2000*

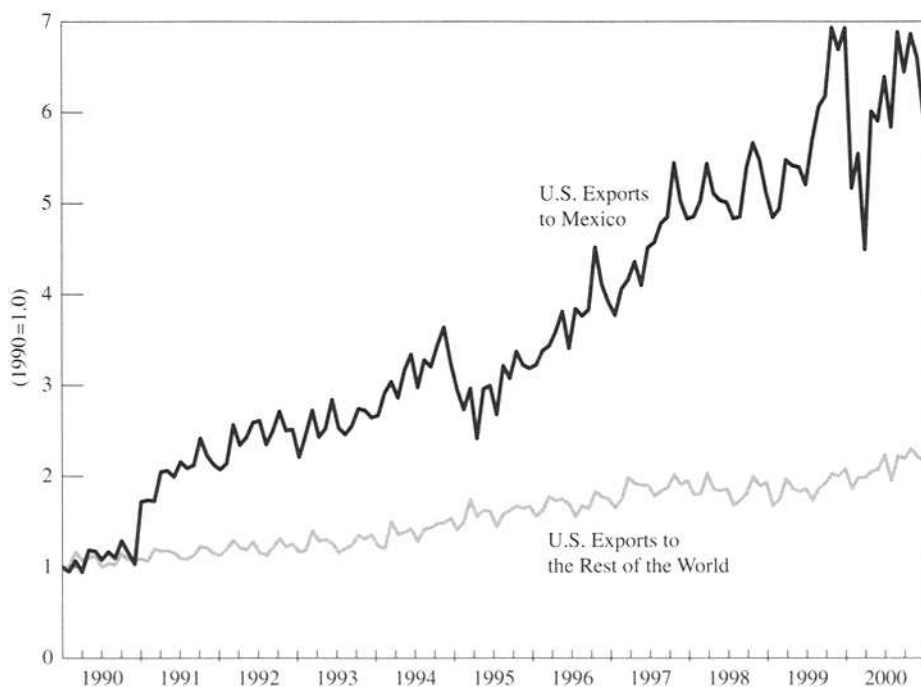
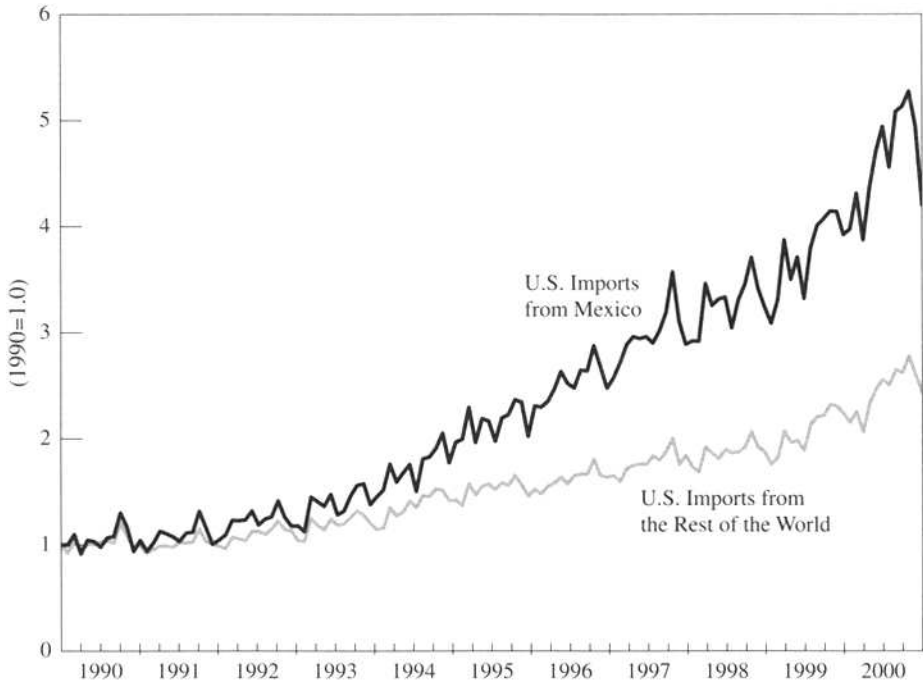


Figure 4
*Growth of U.S. Imports from Mexico and
 from the Rest of the World, 1990–2000*



(2001) discuss how firms employing high-skilled American workers produce intermediate goods, ship them to Mexico for assembly by lower skilled Mexican workers, and then import the finished products back to the U.S. for final sales. Industries such as textiles, agriculture, and automobiles have reaped large gains in efficiency from this cross-border trade (Zoellick, 2001).

It is possible that some of this increased trade represents what Viner (1950) called trade diversion rather than trade creation. Trade diversion would occur if NAFTA caused trade to be diverted from lower cost non-NAFTA producers to higher cost NAFTA producers. Trade creation would occur if NAFTA caused production to move from a higher cost site in one NAFTA country to a lower cost site in another NAFTA country. Krueger (1999), investigating this issue, found evidence that NAFTA tended to create trade rather than divert trade. She found, for instance, that those commodity categories in which Mexican trade with the U.S. grew most are the same categories in which Mexican trade with the rest of the world grew most. However, even if NAFTA did divert some trade away from non-NAFTA countries, this would not reduce welfare in member countries. The U.S. and Mexico still have the option of buying from

products in nonmember countries. If they chose to divert purchases to NAFTA countries, this is because the free-trade agreement made products in member countries cheaper than the products previously purchased from nonmember countries.

While NAFTA has increased welfare in member countries through trade creation or trade diversion, its greatest benefit to the U.S. has been perhaps from a foreign policy perspective. The U.S. border with Mexico exceeds 2,000 miles. Mexico has a population of 90 million, and economic stagnation in Mexico causes surges of illegal immigrants to enter the U.S. The U.S. has interests in a politically stable and economically prosperous Mexico. NAFTA has contributed to this by strengthening the political forces pursuing economic freedom and democracy in Mexico.

Until the early 1980s Mexico's economy was characterized by protectionism, macroeconomic mismanagement, and government-run industries. Production-weighted tariffs at this time averaged 24 percent (Lustig, 2001). These high tariffs plus quantitative restrictions governed most imports (Krueger, 1999). Huge fiscal deficits caused inflation rates to average more than 100 percent per year in the 1980s. Inefficient government-owned industries lost millions of dollars.

Over the last 15 years Mexico has adopted a new development strategy. During this time, "the tendency has been for the market to replace regulation, private ownership to replace public ownership, and competition, including from foreign goods and investors, to replace protection" (Lustig, 2001, p. 85). In 1986 Mexico joined the General Agreement on Trade and Tariffs, and production-weighted tariff averages fell to 11 percent. Fiscal deficits almost disappeared in the 1990s, and inflation is now in single digits. Deregulation and privatization have taken place in several sectors.

As Zoellick (2001) discusses, from a political perspective NAFTA is the cornerstone of the new development strategy. The promise of access to markets in the U.S. strengthens the hand of export interests and other groups in Mexico that favor liberalization. Zoellick further discusses how, as in East Asia, economic liberalization in Mexico following NAFTA has led to political liberalization. Until the early 1990s, the Institutional Revolutionary Party (PRI) had a monopoly of power. Currently, however, both the president of Mexico and the leaders of one-third of the states are from opposition parties.

NAFTA also helped Mexico weather the 1994–1995 peso crisis and quickly recover. As Zoellick (2001) discusses, during the 1981–1982 crisis, Mexico raised tariffs on U.S. goods to 100 percent and imposed non-tariff barriers. During the 1994–5 crisis, Mexico continued to lower tariffs with the U.S. according to NAFTA stipulations. The resulting open borders between the U.S. and Mexico contributed to the explosion of trade shown in Figures 3 and 4. In 1995, exports from Mexico to the U.S. grew 28 percent. As Lustig (2001) notes, these exports were the engine of Mexico's recovery.

The U.S. interests in a quick recovery can be seen by comparing Mexico's recovery with what happened in Indonesia after the Asian Crisis of 1997. Indonesia depends on Japan for much of its exports, just as Mexico depends on the U.S. For a variety of

reasons Indonesia had trouble exporting to Japan after the crisis. This has kept Indonesia's economy stagnant for the last four years. As a result, piracy and crime has multiplied off the Indonesian coast on the major channel through which Japanese cargo flows to the world. Japan is thus paying a high price for its neighbor's economic stagnation.

VI. Conclusion

NAFTA passed Congress in 1993 amidst virulent debate. Detractors such as Ross Perot argued it would lead to a "giant sucking sound" of jobs migrating south. Mainstream politicians argued it would lead to large job gains. Many mainstream economists were skeptical of these claims. Since the U.S. economy is far larger than Mexico's economy most economists anticipated small employment effects. They did, however, expect large gains from trade.

The experience of the last eight years indicates that while the employment effects have been small, the increase in trade has been enormous. The growth of exports and imports between the U.S. and Mexico far out strapped the corresponding growth between the U.S. and the rest of the world. This explosion of trade has produced gains from trade as predicted by the theory of comparative advantage.

In addition to these efficiency gains, NAFTA has helped Mexico to recover from the peso crisis and to liberalize politically. The ability to export to the U.S. was a crucial factor helping Mexico recover from the 1994–1995 crisis. The promise of access to U.S. markets also strengthened the hand of interest groups pursuing privatization, deregulation, and liberalization. Mexico has made great strides in this direction over the last 15 years, and economic liberalization has been followed by political liberalization. The Institutional Revolutionary Party lost its long held monopoly of power as the president and the leaders of one-third of the states are currently from opposition parties.

The emerging liberty and prosperity in Mexico in turn benefits the U.S. The two countries share a 2,000 mile border and the U.S. has strong geopolitical interests in a stable and democratic Mexico. From America's point of view, NAFTA's greatest legacy might be the contribution it is making to economic growth and political freedom in Mexico.

NOTES

¹This section draws on the *Economic Report of the President* (1993) and Lustig (2001).

²Hinojosa et al. (2000) report that total NAFTA-TAA certifications over the first 65 months averaged 3,662 workers per month. Of these, 65 percent were related to Mexico, 18 percent were related to Canada, and the rest were unspecified. Assuming all the unspecified cases applied to Mexico, the number of workers certified as being dislocated by trade with Mexico would average 3,003 workers per month.

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